Nick: Hello. Good morning. And today is Saturday, the 4th of November, and this is yet another episode of Two Gray Beards. Well, what a week we've had, Andy.

Andy: It sure was. What a crazy week.

Nick: Yeah, it was it was a spectacular week. We're glad that we got in QRA. What do you think was the sequence of events which precipitated this amazing move that we had in both equities and bonds?

Andy: Yeah, I'm going to focus, I'm sure you're going to focus on a more broad set of topics, but let me just focus on the QRA. I think there were other topics that conspired to have the reaction that we had. But the QRA was a surprise to the markets. And frankly was not what We expected, or certainly what I expected.

And in particular, what I did expect and what actually happened was the treasury decided to issue the same amount of bonds they had planned for the fourth quarter. There were some expectations that they might issue more. There were some expectations that they might issue less, but by and large expectations, including my own, were that they would leave their issuance the same.

However, on Monday, they announced an issuance of 816 billion for Q1, which was above almost every estimate, including my own. But, uh, we found out at 830 on Wednesday and immediately reacted and sent emails to you all that the amount of bonds that they planned on issuing in Q1 was dramatically lower than my expectation and.

Every market expectation I could see. And what that means is there's simply not going to be as many bonds around. For auction as the market expected, and that's very good for assets. And so, both Nick and I, in our Twitter feeds and to you guys at two great beards sending an email said, you got to buy everything.

You got to hold your nose and buy. Cover shorts, get long, go long increase your allocation for long only to equities and bonds.

Nick: Absolutely. I think that I'm going to be slightly more nuanced and say that. The the rally really was set up by the BOJ on Tuesday that did far less of a hawkish move than the market expected, and that already set up the the scene for something that happened.

Accelerated on Wednesday, as you say, when the people found that their positions, which are extremely short duration, anticipating much higher coupon issuance were proved false. And then they started chasing and after Powell was pretty non nondescript, I wouldn't describe him as either hawkish or dovish.

They had to start paying up and then an avalanche just. For the next two days, people just had to cover their positions. The data, to give it's a fair shake was weak. And that certainly did not help because people were not willing to sell in front of the data or get short in front of the data again.

And when the data came out and it was all weakish, let's say nonfarm payroll was a mess. The the earnings were a slight beat, but everything else from the ISM on that we got last week was a bit of a miss and that gave people a lot of food for thought, Ooh, are we going into recession? I don't think we are, but what it does mean is that going forward, we are going to be much more data dependent than we have been up to now.

And that is going to create a whole load of volatility and uncertainty. We are positioned well, but what we have to do is be careful not to be overconfident for the next period, because the next set of data that comes out could completely flip the narrative.

Andy: Yeah, and typically when the term data dependent is used, it comes from a bank, a central banker.

In this case, I think we're now focused more so on data dependent as Forget the central banker, they're on pause, but really what it really means for the economy and markets. And I think that the employment number, which really kicked off a extreme move in two year notes, not an extreme move, a logical move in two year notes to Hey, this could be extrapolated to a, heading into a recession just was ignored by the equity markets, which closed on their highs, just off their highs.

So to me. The data dependence will actually be something that will determine the 2's, 10's shape and 10 year notes versus equities. And so that'll be the nuanced look as data starts to come out. But the bigger picture is on long term assets, the things you guys mostly hold is this supply issue.

And what happened is that in July, the data went from the supply went from 178 billion to 338 billion of new coupon issuance, and in this next quarter, Q1, it'll go from 338 to 348, which isn't a big jump. And so the market retraced some of the move, 50 of the 100 basis points of bond move half of the equity drawdown was retraced in the last three days.

And yet. So that's because it hadn't grown a lot. And yet I'm not confident how the market's going to absorb the 350, 48 billion of bonds that the government is going to sell. They're going to absorb it. They would have absorbed it better if rates had been at 5 percent than they would at close to four and a half percent.

So. I'm a little pessimistic on the outlook for long term assets based on the still sizable issuance and which asset to buy equities versus bonds, which asset to hold equities versus bonds will be, and whether the short term rate moves will be, as Nick said, data dependent, but holding assets in general is a lot less attractive than it was three days ago when we bought them.

Nick: Yeah, absolutely. Now, just to bigger picture, look at it in the bigger picture, I think the likelihood of the term premium on bonds going negative is absolutely zero, because as you rightly say, whether it's 350 billion or 340 or 360, that's a lot of bonds to absorb. And the term premium really should not go negative on that.

It can come down, it can come down relative to what it was. But it's certainly not going to go negative and we're very close to zero now. And therefore I think the likelihood of further rallies is very slight. And also don't forget that real rates have come down a lot. Our tips have done fantastically well, and really it's time to say, thank you very much indeed.

And, probably write some calls or sell some whatever. What we can be absolutely sure is that the likelihood Of term premium going negative again, and real rates going negative again with this level of issuance over the coming quarters is very low. Right.

Andy: I agree with that. So what do we have for data next week?

We have threes, tens and thirties, about 110 billion, 108 billion of auction. Tuesday, Wednesday, Thursday. Data seems light, but Pow speaks?

Nick: That's right. He speaks on Wednesday and Thursday up on the Hill, and if he wants to push back against anything that's happened this week, he's got the platform, the ideal platform to do it.

I think he is unlikely to to push back too strongly. Against anything because why would you ruin the wonderful setup for the auctions for the 30s? Janet would not be very pleased if he did that But on the other hand he could and that's the ideal time for him to do. So I doubt he will as I said,

Andy: I think that's right.

So, if he does we'll email you

Nick: Yeah, no absolutely And really nothing has changed in our longer term outlook. I think we're just going from one extreme of the range to another extreme of the range in terms of term premium from relatively high to relatively low, but we'll probably stay in that range.

And we need to keep on thinking about playing that range because if the market is now even more data dependent, and some people think that we're going into recession. And these are the first indicators of a weakening economy. Then every piece of data is going to be extremely important, especially inflation and employment.

And we need to be playing the range in the meantime before we decide which way we are finally going to go. But that we won't know for several weeks, will we, Andy?

Andy: Right. We're not going to get much meaningful data until well, we'll get CPI and PPI and we'll get the normal sets of data. I guess what I would say is this, there's Been three possibilities, which is the economy would weaken, inflation, would fall on its own.

There's been with the preponderance of tightening that has occurred the variable lags that they like to talk about, there's a possibility that it'll take, it will not fall at all. That the, there just hasn't been enough tightening and the large fiscal stimulus will continue to keep the economy afloat.

And then there's the idea that the way it has to play itself out is long rates have to stay high enough. To cause equities to sell off to cause equity demand to fall and to cause the labor market to ease. And I guess what I'd say is the third one, which is my central case took a step back, went by what the QRA data suggested and rallied long term rates, 50 basis points and equities.

So, I think that is now. Less likely in the very short term to have an effect and so the question is, okay, fine. The forcing mechanism of policy, the, that that Janet reversed is going to increase the odds of the second outcome, which is things stay higher for longer and decrease the outcome of the first Outcome, which is the economy weakens and that's where I'm at.

I think it's more likely that we are going to see, a temporary drop further drop weakening and data that reaccelerates then heading into a recession. Without a doubt, we're going to need a month or 2 more of data to determine which way we're going. And for now, it just seems that. Assets have corrected entirely in terms of this term premium, such that they have very little room on the upside.

And so, I think we're in agreement on what the next step is for our portfolio.

Nick: Yeah, no I completely agree. I think of the markets in terms of probabilities. And really the probability of, as I said, of term premium going negative, I think is. Almost zero. I think the probability of real rates going below zero is also Very close to nothing and therefore I think the correct response here is to sell some calls but for people who don't trade options is to lighten up on their holdings because this is about as good as it's going to get But i'm going to cover all that in my segment next perfect Sounds great.

Thank you very much indeed. See you next week. See you next week. Bye. Here are our allocations, and we have done pretty well. We're back to 269, 000. We made... Nearly 3 percent on the week, so we entered correctly. Now, what we must do is we must make sure that we keep that money, as opposed to frittering it away over the course of the next week.

And as we told you, we think the best way to do that is by writing some options.

The best to decide what the strike should be, let's have a look at the market action last week. We're not trying to run a hedge fund here. We're not trying to absolutely maximize our returns. What we are trying to do is do what is sensible for the long run. And we think that after a run like we had over the past week, for the reasons that we mentioned, the market is most likely to go sideways.

certainly in SPY, certainly in DIA, which had an even bigger move in terms of what it reached. And we think it'll, just go sideways as probably TLT backs off and probably TIP backs off most because you can see. how overbought it got. So we are going to do a mixture of at the money or slightly out of the money and slightly in the money because all we're trying to do in this portfolio really is to keep its longer term value.

We don't want to be completely out of positions because we want to keep positions for the long term. However, at this point we are fairly confident that whatever we sell up here. In the short term, we will be able to buy back or even buy back cheaper because as we said, we think the market is now going to be very data dependent and we are not going to have any data for a while and that is why with things selling calls.

A mixture of in the money and out of the money is going to be the best strategy here. So what have we decided to do? And these are the strikes that we have picked out in the Dow Jones 341 call, in the SPYs the 434 call, in TIPS the 104 call. and in TLT the 88 call. So some are slightly in the money and others are slightly out of the money and we look at them as TIP and TLT together and the DAO and the SPY together.

We don't think that we're going to get exercise probably on any of them but we shall see we never know. So what we've decided is to go as short as possible which is next Friday. expiry as a the only one that isn't is tip because the closest expires i've written down here is actually the friday after this is not going to make us a fortune it's going to make us some money We think it's the prudent thing to do because it's likely that the market will retrace after this huge run up it had last week.

And therefore we might as well make some money out of it or lose some of these positions. And if so, so be it. We are quite confident, as I just said, that we will be able to buy them back cheaper in the longer term. I've updated the chart pack. All the broker statements are uploaded as is the month of October.

So all you need to do is click here and everything will be, will appear for you. Once again, the order entry. It's the DIA, the SBY, the tip and the TLT the first. Those three are for November the 10th, as you can see, tip to November the 17th, and we'll execute all that on Monday, hopefully very close to where the close was.

Thank you very much indeed, and have a lovely weekend.